APPENDIX

FOMC NOTES - PRF
February 4-5, 1997

Mr. Chairman:

I will be referring to the charts distributed on the table.

After your last meeting, U.S. forward, short-term rates continued to back up but, as you can see, not to the levels reached last July and late August; in the last week or so they have stabilized and even backed down a bit in the past two days from Friday's levels reflected in the first panel. German and Japanese forward rates, however, have remained quite low.

This pattern of forward rates reflects expectations that a firming action by the Committee is not thought to be imminent but was, until just recently, thought to be likely sometime later this year. There are really no prospects for an increase in rates by either the Bundesbank or the Bank of Japan in the near future. The compression in German forward rates seems to me to incorporate some possibility for a further ease by the Bundesbank. Japanese forward rates I think reflect the market's looking past the current position of the Japanese economy to focus on the risks that increased fiscal drag in the new fiscal year, starting in April, will slow the economy down yet again.

The most notable development since your last meeting has been the rapid rise of the dollar to levels not seen since June 1994 against the mark and February 1993 against the yen.

With the unwinding of the heightened expectations for a tightening by the Committee early last September, the dollar's interest-rate advantage began declining through late November as you can see on the second page. At that point, it was an increasingly-fashionable, minority view that the Committee's next action would be an ease, as the economy was thought to be slowing down.

There was then a relatively sharp reversal of both expectations and the trend in interest-rate differentials early in December, as I described at your last meeting. This shift appeared to be vindicated by the late December and early January data releases, which pushed up our bond yields and brought 10-

year differentials with Germany and Japan to their highest levels in this decade -- though still well below the levels which prevailed in the late 1980s.

While the widening of the U.S. interest-rate advantage has played a role in the dollar's sudden climb. I think it has really served to summarize and underscore the market's pessimistic assessment of German and Japanese prospects. The dollar held up quite well in the fall when the differentials were narrowing. Both then and now the market's strong presumption has been that risks in the U.S. remain on the upside, while in Germany and Japan they are seen as decidedly on the downside.

Looking forward, at the risk of stating the obvious, it seems to me that there are "fat tails" on both sides in the distribution of the dollar's potential moves from here.

An unexpected pickup in growth in Germany or Japan, or a sudden acceleration of inflation in the U.S. which significantly affected bond and equity prices, could cause the dollar to sell off sharply. On the other hand, if the market's pessimistic outlook for Germany and Japan were to be vindicated, and if the fragile Japanese banking system were to crack, while the U.S. economy were to accelerate, then the dollar could rise quite a bit further.

There are many in the market who are convinced that the yen will begin to strengthen sharply against the dollar when the Bank of Japan begins to raise rates. I am skeptical. First, I do not think that this day is near at hand. Second, when it does come, I think there is a possibility that the Japanese authorities will find, as we did in 1994, that when you start to raise interest rates from very low levels there are considerable capital losses to be incurred on bond and equity holdings along the journey of narrowing their large negative interest-rate differentials.

Coming back to the here and now, the dollar has lost some of its rapid, upward momentum in the last few days as market participants have focused on the combination of the muted fourth quarter price data as well as the prospects for our first quarter to be slower than the fourth quarter. As a consequence, our bond yields have declined by around 20 basis points in recent days and our 10-year differentials with Germany and Japan have each fallen back a bit from the levels reflected in the middle panel, as of Friday. However, the dollar has continued trading around 122 against the yen and 1.64 against the mark. There still seem to be many who "missed" the dollar's rally, and this appears to be keeping the dollar well bid.

Turning to domestic operations:

The turn of the year occurred with only the usual degree of pressures in the funds market. While we did reach new lows in operating balances in late January, the market hardly seemed to notice.

On page 3 of your chart package, each of the three panels depicts the Fed funds daily trading range and effective rates for the four maintenance periods in December and January which surround each of the last three year-ends: '94 to '95; '95 to '96; and '96 to '97. You can also see the period average operating balances for each maintenance period, which have declined from a range of 30 to 25 billion in 1994-95 in the top panel, to 21 to 18 and a half billion this year.

On the next page, the same periods are shown, but instead of the daily trading range (which includes the high and low trades regardless of the volume traded) here on page 4 the vertical blue lines depict the funds' rates within one standard deviation of the effective rate, which measures deviations from the effective rate weighted by volumes traded. In the bottom panel, you can see the two days -- indicated with the heavy arrows -- when operating balances reached new lows of 15.5 and 15.3 billion, to so little apparent effect.

This information is summarized on the final page in a table which shows the number of days, in each December-January period over the last three years, when the trading range was wider than 50 and 100 basis points, when the effective rate deviated from the target rate by more than 10 and 25 basis points and when one standard deviation of Fed funds trading surrounded the effective rate by more than 10 and 25 basis points.

Over the last three years, there has been a discernable increase in the number of days on which the trading range varied by more than 50 and more than 100 basis points. But it is much harder to find significance in the year-to-year comparison in the variance of the effective rate or the standard deviation.

In short, my general impression has not changed: with the gradual decline in operating balances that we have experienced to date, while we have seen a modest increase in the range of the funds rate, so far the bulk of the market's activity continues to occur in patterns that appear to reflect the familiar ebb and flow of demand and supply for reserves.

However, as I have mentioned before, we continue to have somewhat more frequent difficulties in forecasting applied vault cash and required reserves. Also, while forecasting Treasury balances around tax payment dates is always tricky, we are increasingly aware that, with declining operating balances in the banking system, a given miss in our forecast for the Treasury balance represents a larger percentage of banking system balances.

Looking forward to the upcoming inter-meeting period, I would like to request the Committee's approval for an increase in the Desk's inter-meeting leeway for outright purchases from the current 8 billion to 12 billion.

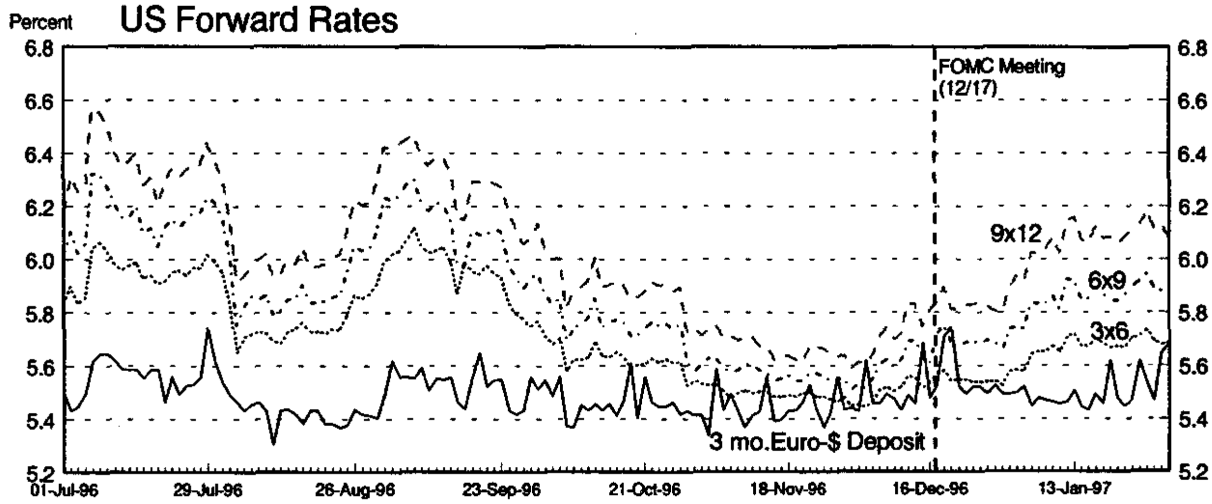
Our current forecasts are for reserve needs to grow by almost 13 billion by the maintenance period before your next meeting. As I mentioned in December, I plan to conduct coupon purchases of around 6 billion over the course of February which, on current forecasts, would leave roughly 7 billion in continuing reserve needs by the end of the period.

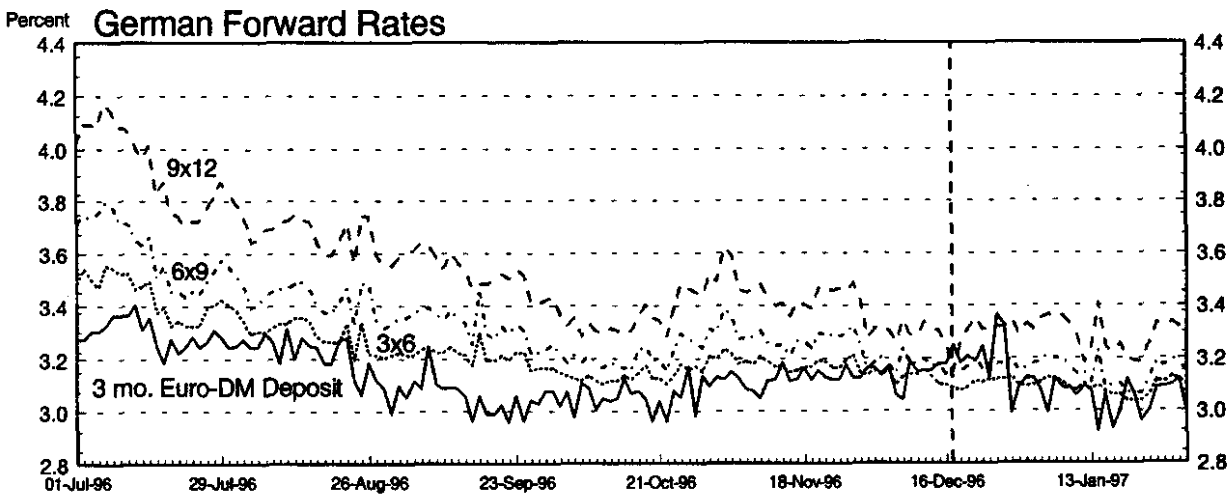
I am quite comfortable meeting needs of this size through temporary operations and, if the future conforms to our forecasts, this may be the preferable course of action. Given our forecasts for virtually no growth in required reserves, continuing needs of this size give us some cushion against the risk that required reserves actually decline. However, depending upon the pattern and size of daily reserve needs in March, we might also want to purchase 2 or 3 billion in bills which, together with our 6 billion in coupon passes planned for February, would either exhaust or exceed by 1 billion our current 8 billion leeway.

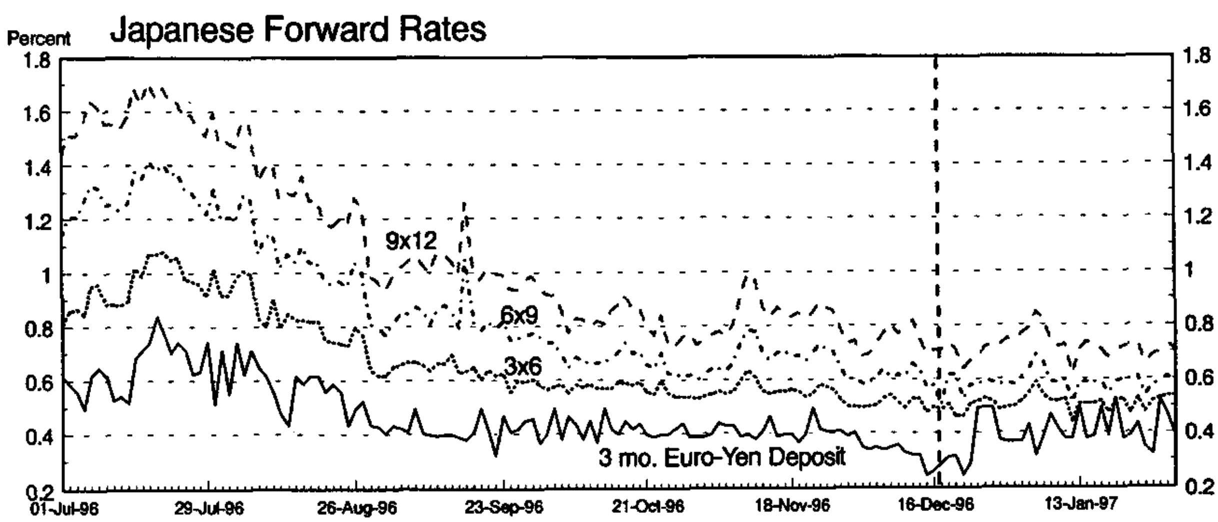
Additional flexibility in a higher leeway is desirable from my standpoint because the future is frequently less tidy than our forecasts. If instead of no growth in required reserves, we actually experience even modest growth, then a larger bill pass could be desirable. In addition, with the fixed date of the Japanese fiscal year end looming on March 31st, and given the recent reassessments of the weaker Japanese banks, we face the risk that the Desk may be asked to accommodate a sudden need to liquidate securities by the Japanese authorities to facilitate their management of any extraordinary dollar funding needs of the Japanese banks. The higher leeway would help us in managing this contingency.

Thus, I would like to request the Committee's approval for an increase in the intermeeting leeway from the current 8 billion to 12 billion.

Mr. Chairman: we had no foreign exchange intervention operations during the period. But I will need the Committee's ratification of the Desk's domestic operations during the period. I will be happy to answer any questions.







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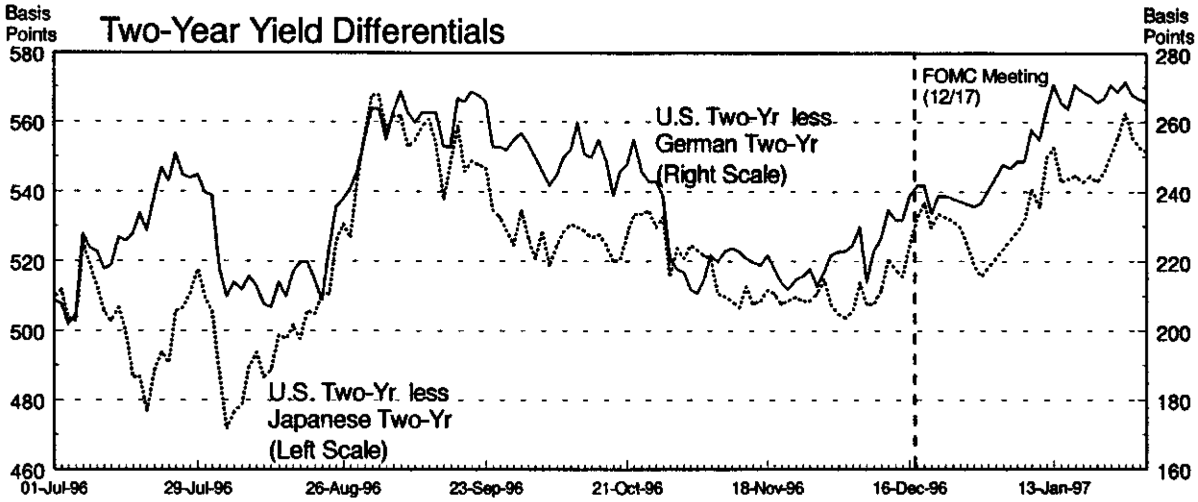
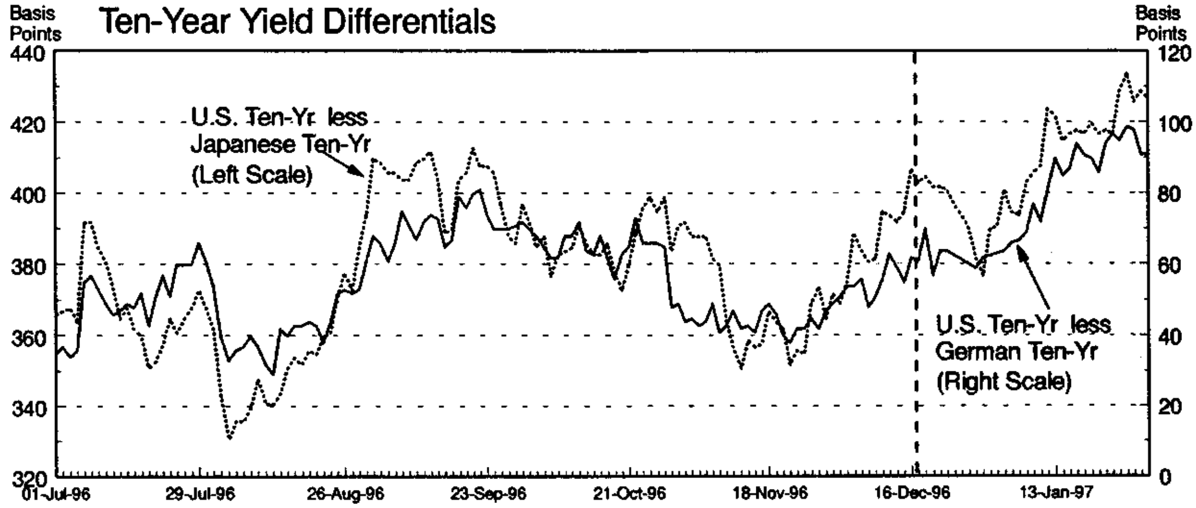
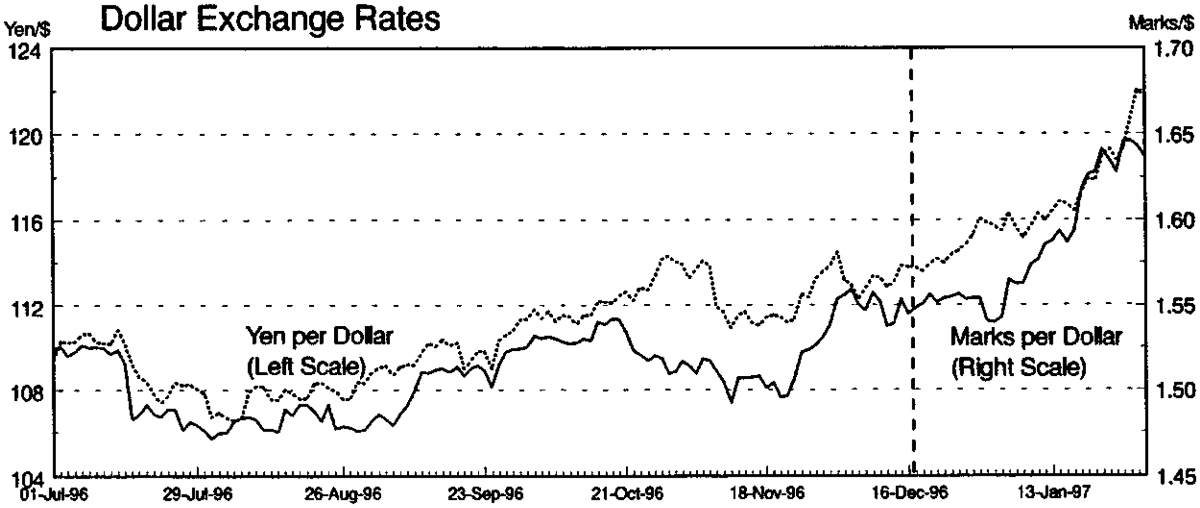
Two-Year Yield Differentials



Ten-Year Yield Differentials



Dollar Exchange Rates



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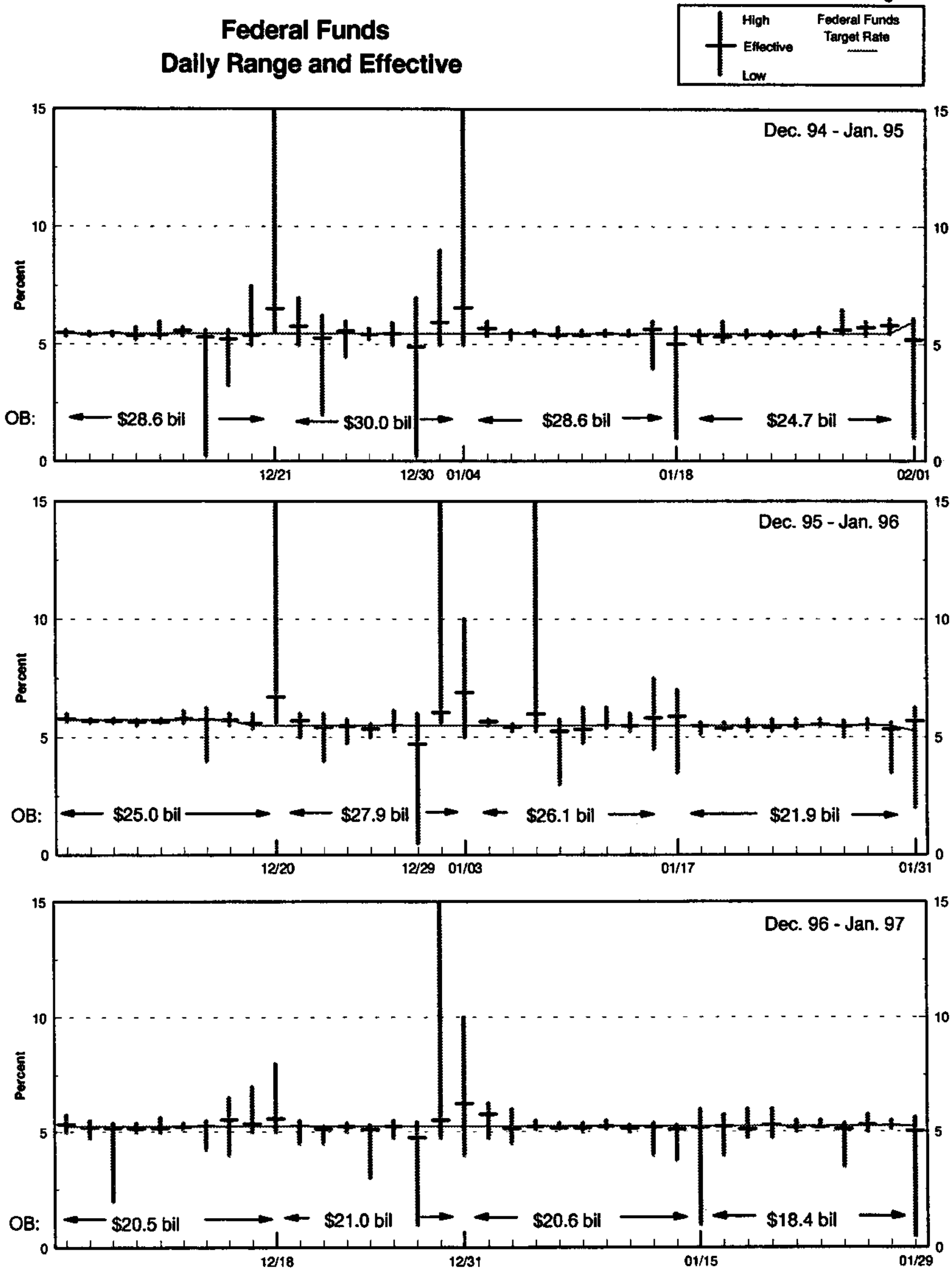
Federal Funds
Daily Range and Effective



OB - Period Average Operating Balance

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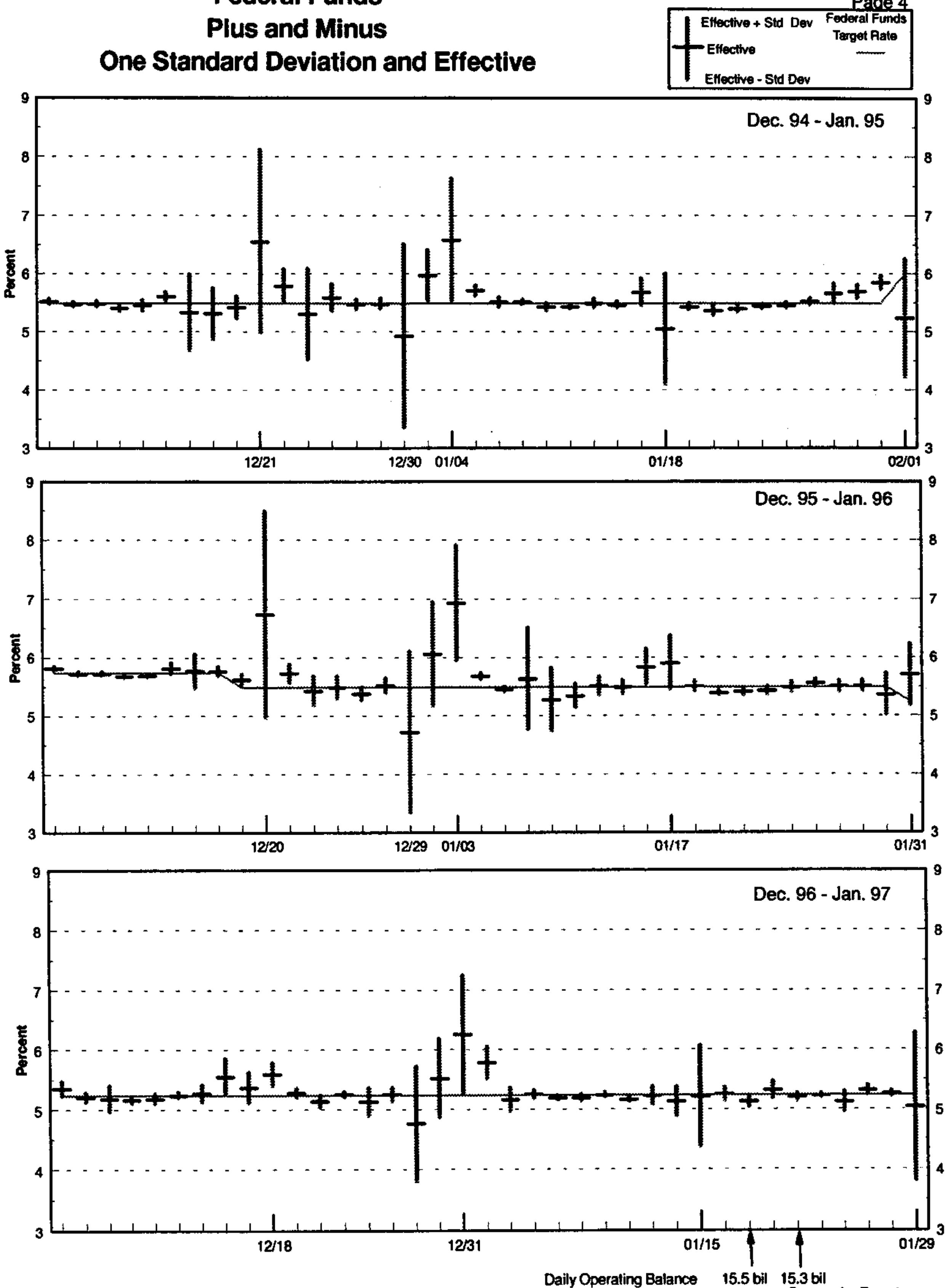
Federal Funds
Plus and Minus
One Standard Deviation and Effective



Cassandra Bryant
Markets Group, FRBNY

FEDERAL FUNDS MARKET:
FOUR MAINTENANCE PERIODS
SURROUNDING YEAR-END
(number of days)

	1994-95	1995-96	1996-97
Daily trading range			
more than 50 b.p.	20	21	25
more than 100 b.p.	13	13	18
Deviation of effective rate from funds target			
more than 10 b.p.	17	15	12
more than 25 b.p.	8	7	5
One standard deviation around effective rate			
more than 10 b.p.	16	18	19
more than 25 b.p.	10	11	7